

Internal Revenue Service
memorandum

CC:FS:TL-N-103-92
FI&P:MNelson

date:

to: CEP Team Coordinator, [REDACTED]

from: Chief, FI&P Branch (Field Service) CC:FS:FI&P

subject: Section 7702

This is in response to your request for technical advice dated September 20, 1991, concerning the application of section 7702(f)(7) of the Internal Revenue Code to a contract issued by Taxpayer. Your question is whether any increase in death benefit under a cash value accumulation test life insurance contract automatically results in application of the adjustment provision in section 7702(f)(7). You have also asked whether the computational assumption of section 7702(e)(1)(D) as to maximum allowable endowment benefit requires comparison to the death benefit at issue or to the death benefit after the increase. We conclude that section 7702(f)(7) treats the entire contract as reissued with all factors under the cash value accumulation test redetermined as of the date of the increase in death benefit.

Facts

The contract issued by Taxpayer is a flexible premium, adjustable death benefit, single insured life insurance policy. The contract specifies (1) no policy fee or expense charges, (2) maximum mortality charges based on the 1980 CSO nonsmoker gender based table, and (3) a minimum annual interest rate guarantee of four percent. The actual interest rate credited is expected to be well in excess of the minimum although no greater guarantee is made.

The contract has been designed to comply with the cash value accumulation test under section 7702(b) of the Code, which provides that the cash value may not, at any time, exceed the tax net single premium required to fund future benefits under the contract. The premiums permitted by the contract are larger than would be required to fund the future benefits if the cash value accumulation test used the interest rates currently guaranteed in the contract. Because the interest rates specified for use with the cash value accumulation test are lower than those that will actually be credited to the contract, however, the Taxpayer has represented that the

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contract, by its terms, satisfies the cash value accumulation test at issue.

Because of the amount of premiums paid and the rate at which interest will actually be credited (as opposed to the comparatively low interest rate assumed for purposes of the cash value accumulation test), the cash value of the contract can eventually be expected to reach a level that would exceed the net single premium for the future benefits. The cash value can also be expected to exceed the least amount payable as a death benefit under the contract in violation of the computational assumption of section 7702(e)(1)(D) of the Code. To prevent failure of the cash value accumulation test due to the contract's high cash values, the contract contains a formula that requires an increase in the death benefit whenever the ratio of cash value to death benefit falls below a specified trigger. Both option 1 and option 2 versions of the contract specify that the minimum death benefit will not be less than the cash value plus an additional amount equal to a specified percentage of the cash value. Taxpayer states that this percentage is based on a reciprocal of the tax net single premium. This minimum ratio of death benefit to cash value is separate and distinct from, and provides a greater death benefit than, the cash value corridor of section 7702(d).

The computation of the amount of the death benefit is based on certain defined factors. The Selected Face Amount is the initial death benefit while the Minimum Face Amount is calculated according to a specified, age-based percentage of the account value. The account value consists of premiums paid plus earnings less deductions and is equivalent to cash value for federal tax purposes. The minimum death benefit is calculated differently depending on whether the contract is an option 1 or option 2 contract. For an option 1 contract, the death benefit is the greater of the Selected Face Amount or the account value plus the Minimum Face Amount. For an option 2 contract, the death benefit is the account value plus the greater of the Selected Face Amount or the Minimum Face Amount. Accordingly, once the Minimum Face Amount plus the account value exceeds the initial death benefit, the death benefit increases.

The operation of the formula for increasing the death benefit once the Minimum Face Amount plus account value exceed the Selected Face Amount can be illustrated through examples drawn from the provided sample policy. For a male aged 40, 50, or 60, the policy requires Minimum Face Amounts of 244 percent, 153 percent, or 91 percent of the cash value, respectively, which amounts are then added to the cash value to determine the death benefit. The two factors result in a minimum death benefit (account value plus Minimum Face Amount) equal to 344 percent, 253 percent, and 191 percent of the cash value for

ages 40, 50, and 60, respectively. The corresponding numbers for the cash value corridor are 250 percent, 185 percent, and 130 percent, respectively.

If the contract's compliance with the cash value accumulation test is redetermined based on a deemed reissuance of the entire contract whenever the death benefit is increased, the increased endowment benefit will not exceed the tax net single premium for the newly increased death benefit. The Taxpayer's actuary anticipates that there will be a continuing, recurring need to increase the death benefit as the initial premium, subsequent premiums, and earnings thereon increase the cash value of the contract. If proper adjustments under section 7702(f)(7)(A) of the Code are not made with each increase, including retesting with the increased death benefit as the level death benefit under section 7702(e)(1)(A), the contract will fail the cash value accumulation test.

Issue

Is Taxpayer permitted to redetermine the tax net single premium for the entire contract as an adjustment under section 7702(f)(7)(A) of the Code whenever the death benefit increases? If so, is the computational assumption under section 7702(e)(1)(A) applied using the death benefit at issue or the death benefit after the increase?

Analysis

Section 7702(e)(1)(D) of the Code states that, for purposes of section 7702 (other than subsection (d)), the amount of any endowment benefit is deemed not to exceed the least amount payable as a death benefit at any time under the contract. This rule operates in conjunction with section 7702(e)(1)(A), which provides that the death benefit is deemed not to increase. These assumptions ignore anticipated and unanticipated death benefit increases. More generally, the rules do not directly either limit or reflect the contractual terms but instead operate to restrict mathematically the maximum allowable cash values. The computational parameters are used as part of the continuous retesting of a contract to determine the maximum tax net single premium at the insured's attained age that will fund the future benefits as required by section 7702(b).

The computational rules of section 7702(e)(1) of the Code and the cash value accumulation test generally assume an unchanging contract with a level death benefit. The assumptions may not be true as to any particular contract. Not all contracts maintain level death benefits, and many provide

for periodic increases in death benefit upon the happening of specified events. Section 7702(f)(7)(A) provides for proper adjustments for future determinations under section 7702 if there is a change in benefits under (or in the terms of) the contract that was not reflected in any previous determination or adjustment made under section 7702. An increase in death benefit is a change in benefits that was not reflected in the previous determination of compliance with section 7702. The 1984 House Report, H. R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2, (1984) at 1448, states

Changes in the future benefits or terms of a contract can occur at the behest of the company or the policyholder, or by the passage of time. In the event of an increase in current or future benefits the limitations under the alternative tests must be computed treating the date of change, in effect, as a new date of issue for determining whether the changed contract continues to qualify as life insurance under the definition prescribed in the bill. For example, under the cash value accumulation test, if a future benefit is increased because of a scheduled change in death benefit or because of the purchase of a paid-up addition (or its equivalent), such a change will require an adjustment and new computation of the net single premium definitional limit.

The language of the 1984 Senate Report, 1 Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984: Explanation of Provisions Approved by the Committee on March 21, 1984, (S. Comm. Pmt. No. 169) (1984), at 577, is similar but even more clear as to the retesting of the entire contract in the event of an increase in benefits.

Changes in the future benefits or terms of a contract can occur at the behest of the company or the policyholder, or by the passage of time. However, proper adjustments may be different for a particular change, depending on which alternative test is being used or on whether the changes result in an increase or decrease of future benefits. In the event of an increase in current or future benefits, the limitations under the cash value accumulation test must be computed treating the date of change, in effect, as a new date of issue for determining whether the changed contract continues to qualify as life insurance under the definition prescribed in the bill. Thus, if a future benefit is increased because of a scheduled change in death benefit or because of the purchase of a paid-up addition (or its equivalent), such a change will require an adjustment

and new computation of the net single premium definitional limit.

The plain meaning of the statute, as supported by the legislative history, indicates that an increase in death benefit is an adjustment event, however caused. All increases in death benefits, even those that are scheduled or anticipated, are disregarded in the initial computations of allowable values under section 7702 of the Code, by reason of the computational rule of section 7702(e)(1)(A). Accordingly, any increase in death benefits is a change in benefits that was not reflected in any previous determination or adjustment and is an adjustment event under section 7702(f)(7)(A). If the contract is subject to the cash value accumulation test of section 7702(b), the entire contract is treated as newly issued at the time of the change, and the computational rules of section 7702(e)(1) are applied using the death benefit then in effect as the assumed level death benefit. Accordingly, if the trigger in the contract causes an increase in death benefits, the increase causes a deemed reissuance of the entire contract and a determination of compliance with section 7702 using the new death benefit as the assumed future death benefit under section 7702(e)(1)(A).

The government's consulting actuary appears to be contending that the computational assumption in section 7702(e)(1)(A) of the Code continues to apply without change unless the death benefit increase results from one of the occurrences specifically listed in the legislative history. Specifically, a scheduled increase in death benefit or the purchase of paid-up additions would constitute an adjustment event under section 7702(f)(7), but other types of increases would not. Accordingly, the reason for the increase would determine whether the death benefit limit on endowment benefits under section 7702(e)(1)(D) would relate back to the initial death benefit or to the newly increased death benefit instead.

We disagree. Sections 7702(f)(7)(A), by its terms, as supported by the legislative history, applies to all changes in terms or benefits that affect computations under section 7702. The broad reach of this provision includes all increases in death benefits without regard to the mechanism causing the increase. The fact that the increase results in retesting using a different death benefit as an operative assumption under section 7702(e)(1)(D) does not mean that section 7702(e)(1)(D) is without purpose. Although a changed policy is retested as a newly issued contract with the minimum death benefit determined from the date of the deemed issue, an unchanged policy will continue to be tested according to the death benefit at issue.

Conclusion

Section 7702(f)(7)(A) specifically provides for adjustments after a change in terms or benefits, which includes an increase in death benefits without regard to the reason for that increase. As part of the adjustment process, the contract is retested under section 7702 using the computational assumptions of section 7702(e)(1). Those assumptions are applied as if the contract were newly issued in its entirety on the date of the change. Therefore, the minimum death benefit under section 7702(e)(1)(A) against which the endowment benefit must be measured will consist of the range of death benefits provided under the contract from the date of the deemed issuance forward.

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